PROMOTERS' LIABILITY: OLD DOMINION *v.* BIGELOW *

IN the well-known case of the *Old Dominion Copper Mining & Smelting Company* v. *Bigelow*,[1] the Supreme Judicial Court of Massachusetts adopted in an extreme and literal form the doctrine that the promoter or organizer of a corporation, so long as he owns or controls all of its outstanding stock, stands in a fiduciary relation to the company. While the company is in his control he owes it the same duty not to sell to it his own property or his own services for more than they are worth, that a trustee owes his beneficiary not to obtain a personal advantage at the expense of the trust. This duty exists and is violated even though he intends to remain the owner of all the capital stock and to manage the company indefinitely as his own private enterprise. It exists and is violated even though he intends to subscribe and pay for all the stock himself without offering a share for public subscription, carries out this intention, and subsequently sells the stock as his own stock in the market. The duty exists and is violated even though he intends to make, and does make, to future subscribers the fullest disclosure as to any profit he may have taken. If, indeed, the organizer does retain all the stock; if the promoter takes all the stock himself and subsequently sells it to the public; or if he makes a full disclosure to future subscribers, he escapes liability. He escapes, however, not because he is innocent but because the corporation forgives him. All the shareholders having assented, the corporation condones the wrong. When, however, the corporation cannot be said to have condoned the wrong it is entitled in equity to a remedy for the injury done it by the promoter's breach of fiduciary duty. When, as in the Bigelow case, the promoter, owning or controlling all the capital

* The author of this article, R. D. Weston, was appointed Master in the matter of two petitions brought by Bigelow in the spring of 1914 for leave to file bills of review on the ground of newly discovered evidence. After he had heard the parties and their evidence and had submitted to counsel his draft report, the petitioner agreed that his petitions might be dismissed, and they were disposed of accordingly in June, 1916.

[1] 203 Mass. 159, 89 N. E. 193 (1909).

stock then outstanding, sells the company his own property for more than it is worth and subsequently, as part of his scheme of promotion, has his company issue more stock to the public without disclosing the amount of profit he has taken, the breach of duty is not condoned by anybody having power to bind the corporation. The promoter has no such power. He cannot as a shareholder or director take any action which will work a condonation of his own wrong. When the subscribers become shareholders, then, for the first time, there are innocent shareholders who have power to bind the company. But they pay for their shares without knowing and, therefore, without forgiving the wrong which the promoter has already done. The wrong does not lie in the promoter's failure to make a frank disclosure to subscribers. It is not done when the public are induced to subscribe. It is done earlier when the promoter takes from the company an unfair price for his property. No wrong is done to the subscribers whom the promoter induces to part with their money by keeping them in the dark. The wrong is done to the company when the promoter does the things which he subsequently fails to disclose. This is the Massachusetts doctrine. Consequently, the corporation can recover full damages, though not a cent of the money recovered will find its way into the pocket of a single subscriber who has been deceived by the promoter, and every dollar recovered may inure to the benefit of shareholders who have never suffered any injury whatsoever at his hands. Consequently, too, the subscribers who are induced to take the company's stock can recover nothing, no matter how grossly they have been misled as to the real value of the company's assets.

The doctrine in this form strikes us as extravagant and fantastic. A fiduciary duty, the breach of which neither does injure nor ever will injure anybody, is inconceivable. It seems very strange that the Massachusetts court, thinking, as it obviously did, that the ignorant subscribers are really deceived by the use which the promoter makes of the corporation, should have elaborated and stoutly maintained a doctrine which deprives the subscribers of their right to redress, instead of shaping the doctrine so that it would afford them an adequate remedy. We are naturally led to inquire how the doctrine was built up. Can anything apparently so artificial rest on a foundation of plain and substantial equity?

The purpose of this article is to show that the Massachusetts

doctrine as finally developed has no such foundation, but involves a complete denial of rights which in equity belong to subscribers, and also involves the doing of great injustice to promoters.

What I call for convenience the Bigelow case was in fact two cases. They were begun in 1902. There were two cases only because there happened to be two transactions in which separate properties had been sold to the company. One case went first to the full bench on demurrer and was decided in favor of the company in 1905.[2] Both were tried together on the merits in 1907, went again to the full bench, and in accordance with its decision,[3] final decrees were entered in 1909.

The decrees charged Bigelow with the "unrighteous profits" which he and one Lewisohn had made out of the company, while they were engaged in promoting it and while they were in control of its board of directors, by selling to the company their own mining properties for much more than their fair market value. The promoters had paid $1,000,000 for the properties. They had turned them over to the corporation immediately after its organization in 1895 for 130,000 shares of its stock, having a par value of $25 a share and being worth $25 a share in the market. The total value of the shares they got was $3,250,000. But they had been under no obligation to let the company buy their properties for what they themselves had paid for them. They were bound only to turn the properties over to the company for what an independent board of directors would have paid, namely, the fair market value. This was found to be not more than about $2,000,000. The difference between the market value of the properties and the market value of the stock which the promoters had taken, approximately $1,200,000, was the sum for which they were held liable to account as of some time in 1895. With interest this amounted in 1909 to over $2,000,000. The so-called unrighteous profit had in fact been about equally divided between Bigelow and Lewisohn, but Bigelow as one of two joint wrongdoers was held liable for the whole.

If the promoters had done nothing more than sell their own properties to a corporation all of whose stock then issued was owned or controlled by themselves; if they themselves had bought the residue of the company's stock (20,000 shares having a par value of $500,000) and had resold it to the public, they would have

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[2] 188 Mass. 315, 74 N. E. 653.

[3] 203 Mass. 159, 89 N. E. 193.

incurred no liability. It was a part of their scheme, however, to have the company issue the residue of the stock to the public and to make to subscribers no disclosure as to what the promoters had paid for the property or as to the profit which they had taken for themselves, and this scheme had been carried out. The subscribers for the 20,000 shares had bought in ignorance of the promoters' profits and had not assented in any way to the transactions between the promoters and the company.

The following additional facts were found by Mr. Justice Sheldon, before whom the case was tried. They do not all appear in the report, nor were they regarded as material by the court. Bigelow had disposed of all the stock which he had got as the purchase price of the properties some time before the suits were brought; he had remained a director and president of the company till a new board was elected by the stockholders in April, 1902; the new board discovered that the company had a claim against the promoters, a fact that had not been known before even to the officers of the company; and the new board made this discovery seven years after the organization of the company and only a short time before the suits were begun in the autumn of 1902. I mention these facts because they seem to me to have important bearings on the real equities of the case. It was neither alleged nor found that any of the original subscribers still owned their stock when the suits were begun.

The decision of the full bench overruling the demurrer was unanimous. The opinion was written by Loring, J.

When the cases went to the full bench after the hearing on the merits, the court was divided — Loring, Braley, Sheldon, and Rugg, JJ., being of the opinion that the defendant was liable; Knowlton, C. J., Morton and Hammond, JJ., dissenting. Rugg, J. (now C. J.), wrote the opinion for the majority. Knowlton, C. J., wrote a dissenting opinion.

At the same time that the company brought its suits against Bigelow in Massachusetts, it brought like suits against Lewisohn's executors in the United States Circuit Court for the Southern District of New York. The defendants fared much better in the federal courts. They demurred, as Bigelow had demurred in Massachusetts, and their demurrer was sustained first by the Circuit Court,[4]

[4] Old Dominion Mining Co. *v.* Lewisohn, 136 Fed. 915 (1905).

again by the Circuit Court of Appeals,[5] and finally by the Supreme Court of the United States.[6] Mr. Justice Holmes delivered the opinion of the court, which was unanimous.

The Massachusetts cases went again to the Supreme Court of the United States on writs of error from the final decrees of the Massachusetts court, but on a federal question with which we are not now concerned.[7] The decision affirmed the Massachusetts decrees.

On the facts which I have already stated the Massachusetts court held that Bigelow was liable. If nothing more had appeared the case would have been decided as it was. "There are, however," said the court in the final opinion [8] after the trial on the merits, "certain aspects of the evidence which seem to us to make it [the case] essentially different and materially stronger for the plaintiff." These "aspects of the evidence" do not concern us now, for I am not criticising the decision but the doctrine which the court discussed through twenty pages of the opinion [9] and laid down as applicable to the facts which I have stated. For our present purpose we can discuss the case as if the decision had turned, as the court was prepared to make it turn, wholly on those facts.

The assumption at the root of the Massachusetts doctrine is that, in a case like the Bigelow case, subscribers are deceived as to the real value of the company's assets. I do not say that this is laid down as a proposition of law, but I do say that unless it had been assumed as a fact the doctrine of fiduciary duty to the corporation in such cases would never have been dreamed of. The doctrine would never have been invoked unless the court had thought that the promoter had used the company as an instrument of fraud to deceive the public. The opinions in the earlier cases [10] and the opinion of Mr. Justice Rugg himself make it perfectly clear that the court assumed from first to last that in such cases subscribers are in fact deceived. It was assumed that subscribers have a right to believe that the promoters have taken only so much stock as repre-

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[5] 148 Fed. 1020; 79 C. C. A. 534 (1906).

[6] 210 U. S. 206 (1908).

[7] Bigelow *v.* Old Dominion, 225 U. S. 111 (1912).

[8] 203 Mass. 159, 196.

[9] *Id.*, 175–96.

[10] Hayward *v.* Leeson, 176 Mass. 310, 57 N. E. 656 (1900); Old Dominion Co. *v.* Bigelow, 188 Mass. 315, 74 N. E. 653 (1905).

sents the fair market value of any properties they may have sold to the corporation. It was assumed that subscribers have a right to believe that, if the promoters had charged an excessive price, the corporation, acting under their control, would not invite the public to take stock at par without a full disclosure. The doctrine of fiduciary duty was originally designed to afford protection to subscribers.

It is difficult to see why people who subscribe for stock are deceived by the promoters, when, if the promoters subscribe for the stock themselves and sell it again in the market, the people who buy it are not deceived. It is difficult to see why a subscription is so different from any other kind of purchase. It is difficult to reconcile the proposition that in legal contemplation the subscribers are deceived with familiar and well-established rules in the law of sales. We suspect that the courts were too quick to assume that the big promoters with their corporation on the one side and the small subscribers on the other do not meet on an equal footing and that the latter are likely to be overreached. We suspect that if the first case to arise had been one in which all the stock offered for subscription had been taken by a single rich man, the doctrine of the promoters' fiduciary duty to the corporation would not have seemed so plausible.

Although there may be serious difficulties in the way of maintaining it as a proposition of law, I nevertheless intend to assume, for all the purposes of this discussion, what the Massachusetts court assumed, namely, that when a promoter deals with a corporation as Bigelow dealt with the Old Dominion the subscribers are in fact deceived. That an appropriate and adequate remedy should be provided was, as I have already said, the view originally taken by the court. To provide such a remedy was the purpose and the only purpose which the court had in mind.

Serious misgivings as to the soundness of the Massachusetts doctrine rise in our minds when we examine the opinions of the court with care and reflect upon the consequences of applying the doctrine as the court has laid it down, because we soon discover that its reason was lost sight of and its purpose was not accomplished. To begin with, therefore, I intend to show that in the Bigelow case the doctrine was so applied that its purpose was accomplished only to a small extent, if at all, and that a great many people whom Bigelow

had not wronged, directly or indirectly, profited at his expense. Incidentally, I intend to show that the Massachusetts rule, which makes the market value of the stock wrongfully taken the measure of the promoter's liability to account, also fails to accomplish the purpose of the doctrine of which it forms a part. The rule, to be sure, is perfectly consistent with the doctrine as the Massachusetts court finally shaped it, but cannot be reconciled with its original reason and its original purpose.

For the sake of argument and simplicity of illustration, let us imagine a small corporation with $15,000 worth of capital divided into shares having a par value of $1 each. The promoters convey to the corporation properties worth $8,000, taking for them 13,000 shares. Two thousand shares are afterwards sold to subscribers. This keeps the relative proportions substantially what they were in the Bigelow case.

We can first suppose that the subscribers discover what has been done soon after they have paid their subscriptions and while they and the promoters still hold their stock — the promoters their 13,000 shares and the subscribers their 2,000. The corporation would naturally have its choice of three remedies — to compel (1) rescission, or (2) the return by the promoters of 5,000 shares, or (3) the payment by the promoters of $5,000. Any one of these remedies would accomplish substantial justice. The remedy of rescission (1) would work like an emetic. The promoters would disgorge all their stock and would get back their property. This would leave the corporation with cash assets of $2,000. All the stock, 2,000 shares, would be held by the subscribers and would be worth par. The surrender of 5,000 shares (2) by the promoters to the company would not affect the real value of the company's assets. The assets would still consist of property worth $8,000 and cash paid in by the subscribers $2,000, or $10,000 in all. The amount of stock would be reduced and the company's assets would be represented by the 8,000 shares retained by the promoters and the 2,000 shares originally taken by the subscribers. The payment of damages to the amount of $5,000 (3) would increase the value of the assets to $15,000, and each and every share would then have behind it one dollar's worth of property and no more. Any of these remedies would work substantial justice between the promoters and the subscribers.

But unless the remedy be administered immediately the conse-

sequences are likely to be very different. With the lapse of time things are likely to happen which reduce the number of remedies which can possibly be applied, and change greatly the actual effect of applying any one of them. Rescission may become improper or impossible for either of two reasons: (1) The condition of the property may have changed; its value may have been reduced so that restoring it to the promoters would not put them *in statu quo;* its value may have been increased so that it is not right to ask the company to restore it for what the promoters received as the purchase price. (2) The promoters may no longer hold the stock or be able to buy it in the market. In the Bigelow case involving the mine itself rescission was impossible for both of these reasons. It was impossible in the other case involving what were known as the "outside properties," for the second reason. Bigelow could not do his part in a rescission without returning all the stock that he had got for the property. He had disposed of all his stock and there was in the market no stock which he could buy. This same reason may likewise make it impossible to order the promoter to restore the part of the stock representing his unrighteous profit. After a time the only remedy left is very likely to be, as in the Bigelow case, an accounting for the value of the stock wrongfully taken.

The form of remedy, however, is comparatively unimportant. The important thing is the effect which the application of any one of the remedies has on the real parties — the promoters who have done the wrong and the subscribers who are the persons, and the only persons, who have been injured. If the remedy be not applied immediately the promoters may have disposed of their stock in the market before their wrongdoing has been discovered, and the subscribers may have sold their stock and taken their loss in ignorance of any claim which the company has against the promoters. Such changes in the situation of the parties were regarded as immaterial by the Massachusetts court, but I think it can be shown to a demonstration that they affected the equities in a most material and substantial way. And when I say the "equities" I am using the word not in a popular sense but in a scientific sense.

When, as in the Bigelow case, the promoters have disposed of all their stock, let us see whither the Massachusetts doctrine carries us. I do not mean to intimate that the court did not face the consequences boldly. They did face them not only boldly, but, as I think,

blindly. They pursued their theory that the promoter was a trustee regardless of the sense in which he might be so regarded and the purpose for which he might be so treated.

We are now assuming that the promoters have sold all their stock before the discovery of the claim against them and before suit is brought. The purchasers have bought with reference to the real value of the company's assets. The present holders of those 13,000 shares have presumably paid for them what they were really worth, or $66\frac{2}{3}$ cents a share. They may have paid more. They may have paid less. But whatever they paid, the 15,000 shares of stock had behind them assets worth only $10,000, and $\frac{2}{3}$ of par was all that the buyers had any right to suppose the stock was worth. We will assume for the present that the original subscribers have retained their stock. The company brings suit and recovers $5,000 in damages. This makes its assets stand as follows:

Property	$8,000
Subscribers' cash	2,000
Promoters' unrighteous profit	5,000
Total	$15,000

The subscribers' stock has been made worth what it ought to be, or $1 a share. But in order to accomplish the same result directly the promoters would have had to pay the subscribers only $33\frac{1}{3}$ cents on each of 2,000 shares, or $666.66\frac{2}{3}$ in all. The promoters are in fact required to pay $5,000, and of this amount $4,333.33 goes to the stockholders who bought their stock from the promoters themselves and have not suffered in any way by reason of the supposed wrongdoing.

In the Bigelow case $\frac{13}{15}$ of what Bigelow was ordered to pay, or over eighty-five per cent of $2,000,000, inured to the benefit of stockholders who derived title from the promoters themselves and had not been injured by them.

It would certainly seem that if the corporation is allowed to recover at all it ought in such a case to recover for the sole benefit of those who have in fact been injured by the wrongdoing of the promoters, and then only so much as is required to make the injured persons whole.

It is plain that the original subscribers are the only persons really injured by the wrongdoing of the promoters. But if seven years,

or any other considerable period of time, elapses, many of the subscribers will have sold their stock and taken their loss. Again, we may assume that the selling price is 66⅔ cents a share, representing the value of the company's assets. Purchasers from them buy without knowledge of any claim of the corporation against the promoters, and consequently without any reliance on such a claim. The corporation afterwards discovers the claim and enforces it against the promoters. The purchasers of the original subscribers' shares suddenly find their shares worth par. They have all got 33⅓ cents a share which does not belong to them, but which does belong in equity to the original subscribers who sold at a loss in consequence of the fact that the promoters, in pursuance of their original unrighteous scheme, have kept the subscribers in the dark as to the promoters' profits. If all the original subscribers have disposed of their stock before the promoters are found out, then not a single person whom the Massachusetts doctrine was invented to protect obtains any sort of redress by virtue of the company's recovery. It certainly seems as if the corporation should recover, if at all, only as a trustee for original subscribers who may or may not have parted with their stock.

Another difficulty with the decision (traceable apparently to the same conception or misconception of the promoter as a trustee for the corporation who has wrongfully misappropriated shares of stock) is that the market value of the stock wrongfully appropriated was held to be the unrighteous profit for which the promoter must account. Let us see how the Massachusetts rule works in this respect.

It is notorious that the market value of stock may differ widely from the value of the company's assets. In the Bigelow case the market value of the stock happened to be at least par, while the company's assets could not have been sold in the market for an amount equal to anything like the par value of all the stock. If the company had been wound up the assets, including the $500,000 paid in by the subscribers, would have sold for not more than $2,550,000, while the par value of its outstanding stock, 150,000 shares at $25 apiece, was $3,750,000. This made the shares really worth less than 63 cents on the dollar.

Taking again our small and simple corporation, we may first suppose that the market value of the shares is 50 cents, or ½ of par,

and then that it is \$2, or twice par, and see the result of applying the Massachusetts rule in each case.

The promoters took 5,000 more shares than they should have taken. The company, we will suppose, recovers the market value of these shares. At 50 cents apiece this is \$2,500. The company's assets then stand thus:

Property	\$8,000
Subscribers' cash	2,000
Promoters' unrighteous profit	2,500
Total	\$12,500

To this total the promoters have contributed \$10,500. The subscribers have contributed \$2,000. The promoters and subscribers ought to own the stock in the proportion of 10½ to 2. As a matter of fact, they hold it in the proportion of 13 to 2.

In order to make the subscribers whole the promoters should be required to pay \$5,000 regardless of the market value of the stock. Under the Massachusetts rule the subscribers' stock, for which they have paid par, or \$1 a share, is really worth after the promoters have accounted only $\frac{125}{150}$ of par, or 83⅓ cents. Collectively they have lost, notwithstanding the enforcement of the promoters' liability, \$333.33⅓, or ⅙ of all they put in. If the market value of the Old Dominion stock had been only ½ par and the amount for which the promoters had been forced to account had been ascertained accordingly, the subscribers' loss would have been ⅙ of \$500,000, or over \$83,000.

We are next to suppose that the market price of the promoters' unrighteous profit, 5,000 shares, was twice par, or \$2 a share. The company recovers on this basis \$10,000. Its assets then stand thus:

Property	\$8,000
Subscribers' cash	2,000
Promoters' unrighteous profit	10,000
Total	\$20,000

There are 15,000 shares outstanding, and the subscribers' shares have become worth $\frac{4}{3}$ of \$1, or \$1.33⅓. The subscribers have gained immensely at the promoters' expense. Instead of being required to account at the market price, the promoters ought to have accounted at the price at which the stock was offered to sub-

scribers. The liability of the promoters should be exactly the amount which will make the total value of the assets, as of the time immediately after the sale by the promoters to the company, exactly what the subscribers had a right to think the value was when they agreed to take stock. If the promoters be permitted to pay less, then they retain a part of their unrighteous profit as against those whom they have deceived. If they are forced to pay more, the subscribers get an unrighteous profit at the expense of the promoters.

I have now pointed out that the proposition which the Massachusetts court laid down in the Bigelow case, namely, that the promoters stood in a fiduciary relation to the corporation, did not commend itself to a large majority of the able judges who heard it argued. I have shown that in some circumstances the Massachusetts doctrine may be applied so as to accomplish its purpose and not produce any strikingly inequitable result. But I have also shown that when it is applied as it was in the Bigelow case the results produced appear to be grossly inequitable. We stand appalled when we think that a court of equity was prepared to strip Bigelow of over $2,000,000, the circumstances then being such that $\frac{13}{15}$ of this huge sum would inure to the benefit of stockholders who themselves had never been injured, and whose predecessors in title had never been injured, by Bigelow, and that only a small fraction of it ($\frac{2}{15}$) could by any possibility reach the pockets of the original subscribers, who were the only persons who had ever been deceived or injured by Bigelow's conduct as a promoter.

What I may call "the rule of damages" was a subordinate matter. It happened that the market value of the shares in the Bigelow case was found to be par, which was the price at which they had been sold to subscribers. But if this had not been so — if the market value had been either less or more than the price charged to subscribers — we have seen how this rule would have worked.

We at last come to the vital question: Is the doctrine which the Massachusetts court applied a sound doctrine? It surely is not kind, but is it sound?

The doctrine, as the court applied it, makes the promoter a real trustee or fiduciary not for the subscribers but for the corporation. Consequently, the wrong which he commits is committed not against the subscribers but against the company. If this be

true, then all the conclusions reached by the court follow of necessity.

If the promoter be a real trustee for the company, then the injury which he does to subsequent subscribers is not an injury which he does directly to them, and is not an injury in the nature of common-law deceit, but is an equitable wrong done to the corporation, such as a trustee does to his beneficiary when he sells his own property to himself as trustee at an excessive price. So regarded, the wrong is done to the corporation before the subscribers are taken in either as stockholders or as innocent victims. And if they subsequently assent to the prior transaction between the promoter and the company, this does not mean that no wrong was done. It only means that the beneficiary or corporation, through the action or acquiescence of all its stockholders, forgives the wrong. This was all worked out by the Massachusetts court.[11]

If the promoter be a real trustee for the company, then it also follows that we are not concerned with what disposition the subscribers and promoters may have made of their stock or with any question as to who may be the present shareholders. If a man has abused his power over a corporation to get possession of certain shares of its stock, holds the stock as trustee for the corporation in the ordinary sense, and misappropriates the trust *res*, then, of course, he must account to the company for the whole value. It makes no difference whether the stockholders have or have not been aware that the corporation owned any such asset as an equitable interest in the stock held by the trustee. The company's shares may have been bought and sold in the market for years before the trustee is brought to book, so that the stockholders who benefit by making him account to the company may all be different persons from those who were stockholders when the breach of trust was committed. The corporation directly, and indirectly every person who then happened to be a stockholder, were wronged thereby. The corporation directly, and indirectly every person who happens to be a stockholder when the breach of trust is found out and damages are recovered, get the benefit. But the trustee who has wronged the corporation cannot say that there is anything inequitable in making him restore to the company all that he has wrongfully taken. And it has never been deemed practicable to go further and marshal a

[11] Old Dominion *v.* Bigelow, 203 Mass. 159, 179–93.

company's assets with reference to claims which former stockholders might advance against the amount recovered. This was also worked out by the Massachusetts court.[12]

Finally, if the promoter be a real trustee for the company, no exception can be taken to the rule of damages which the Massachusetts court laid down.

All the results of which I have been speaking follow if the promoter's relation to the corporation, in a case like the Bigelow case, is what the court say it is. We have to go back a step further and ask whether they are right in saying that he is a real trustee and that he ought to be treated as such. It is submitted that they are clearly wrong, and clearly wrong on their own showing.

The essential, the radical, the fundamental difference between a case such as the court imagined the Bigelow case to be, and a case such as the Bigelow case really was, is this: In the case of a real trustee for the corporation the company is the artificial person directly injured by the trustee's wrongdoing. In the promoter's case the subscribers are the persons directly injured. When a real trustee appropriates to his own use shares of stock which he holds in trust for a corporation, the company is the equitable owner and is the person injured. All the stockholders are injured too, but only indirectly, as they are stockholders of the injured company. The same is true if a person, holding the majority of stock in a corporation and managing it by means of a board of dummy directors, sells the company his property at an unfair price and makes the directors ratify the transaction. This the Massachusetts court regarded as a case on all-fours with the Bigelow case. In such a case, however, the corporation is the person directly injured by the breach of fiduciary duty. The minority stockholders are injured only indirectly.

In the promoter's case, if anybody is directly injured then the subscribers are the persons who are directly injured. There is no escape from this as a fact. And if there be no escape from it as a fact, then it ought not to be blinked as a proposition of law. It must be accepted as a proposition of law, and when so accepted the doctrine of the Bigelow case cannot be reconciled with it.

We find the Massachusetts court on the horns of this rather picturesque dilemma. Are the subscribers deceived by the manner in which the promoter uses the company in order to obtain their

[12] 203 Mass. 159, 193, 194.

subscriptions or are they not? If they are not, then the assumption of fact which lay at the root of the whole doctrine was false. If they are, then the doctrine as interpreted and applied takes away from the subscribers, the persons directly injured, the remedy which belongs to them personally and gives it to the corporation which in legal contemplation is a separate and distinct person. I yield nothing to the Massachusetts court in respect to the necessity of treating the corporation as a person separate and distinct from its shareholders.

There can be no doubt that the court believed that in these cases subscribers are deceived, and that it started off with the intention of affording the subscribers a remedy. What aroused the judicial indignation was not that the artificial person, the corporation, was wronged, but that the unenlightened public were induced to pay their money for shares in a company whose assets were not as valuable as they had a right to suppose they were. The subscribers would not put in their money as against the promoter's property if they knew that the property had been overvalued. The promoter intends to mislead them. His scheme is conceived in fraud, and *ipso facto* — in the very nature of the thing — deceives subscribers when carried into effect. In the opinion written by Mr. Justice Rugg we find him using language and quoting with approval the language of other judges so as to leave no doubt that the majority of the court believed that in such cases the subscribers are the innocent victims of a very real sort of fraud. For example, on page 183, he quotes from Jessell, M. R., as follows:

"it is intended to cheat the future shareholders. . . . You can defraud future allottees as well as present allottees." [13]

Again, on page 184, from *In re Leeds and Hanley Theatres of Varieties*: [14]

"When it is said that the promoters stood in a fiduciary position towards the company, that does not mean that they stood in such a relation to these directors and these seven signatories [the persons corresponding to Bigelow's dummy directors and shareholders]. It means that they stood in a fiduciary relation to the future allottees of shares — to the persons who were invited to come in and take up the shares of the company."

[13] *In re* British Seamless Paper Box Co., 17 Ch. D. 467, 471.

[14] [1902] 2 Ch. 809, 823.

Again, on page 184, he quotes Lord Robertson in *Gluckstein* v. *Barnes*: [15]

"The people for whom these gentlemen [the promoters] were bound to act were their coming constituents, the persons out of whose money they proposed to make their gain."

Again, on page 184, from *Pietsch* v. *Milbrath*: [16]

"It [the corporation] is deceived in a legal sense when it is rendered helpless by its managers as to protecting those invited to subscribe for its stock and is then used to aid in defrauding them."

Again, on page 191, from James, L. J., in *In re British Seamless Box Co.*: [17]

"If they [the promoters] were intending, although then constituting the whole company, that other people should come in afterwards to whom what had been done would be injurious, the court would feel no difficulty in saying, as Lord Langdale did in *Society of Practical Knowledge* v. *Abbott*, 2 Beav. 559, that they intended to commit a fraud."

At pages 189 and 190 Mr. Justice Rugg himself uses these words:

"But the vicious intent looks forward to the procurement of money from the ignorant public by means of original subscriptions, and the execution of this evil intent extends backwards to contaminate the sale and its profit."

And in *Hayward* v. *Leeson* [18] Mr. Justice Loring, delivering the opinion of the court, had said:

"The persons to whom the promoters owe the duty which they owe by reason of their fiduciary relation are the persons who put their money into the enterprise at the invitation of the promoters, that is to say, the future stockholders, . . . if the promoters undertake to make to themselves remuneration for their services as promoters, without making a full disclosure of the fact to future stockholders, their principals, and getting their consent, they are guilty of a fraud."

Such language as we have quoted was not used hastily and inadvisedly, but soberly, discreetly, and in the fear of God. It is plain that all the judges thought that an injury in the nature of fraud was actually done directly to the subscribers. It is inconceivable that

[15] [1900] A. C. 240, 257. [16] 123 Wis. 647, 656. [17] 17 Ch. D. 467.
[18] 176 Mass. 310, 320, 57 N. E. 656 (1900).

the Massachusetts court, or any other court, should have consciously and deliberately intended to deprive them of their remedy. Such a proceeding would violate all our notions of justice and equity.

To take away their remedy from subscribers and give it to the corporation is well enough, so long as you can do them substantial justice without doing substantial injustice to the promoter. We have seen that this may be the result of applying the Massachusetts doctrine in some cases. But when you apply it to a case like the Bigelow case, we have seen that you may not be doing justice to a single subscriber and that you are certainly doing great injustice to the promoter. If I have been defrauded by somebody, and a court of equity says that some company in which I once happened to own stock can recover for my protection without any obligation to account to me, it is manifestly absurd. If I have sold my stock, the company's recovery does not help me a bit. If the same court says that, because I have been defrauded, the company, in which I happened to be a stockholder, can recover ten times as much as is required to make me whole, then palpable injustice is done to the wrongdoer. But such are the consequences of the Massachusetts doctrine. Such are the consequences of taking away the remedy from the persons really injured, of treating the corporation as if it were the person really injured, and of swallowing the fiduciary theory, bait, hook, and sinker.

It is curious to see how the acceptance of the doctrine in its literal and rigid form led the court into a quagmire of inconsistencies, irrelevancies, and self-contradictions. They are discovered in the way the court dealt with four classes of cases closely related to the case at bar.

1. Cases where the organizers intend to retain all the stock and to manage the company as a private enterprise without inviting the public to subscribe.

2. Cases where the promoters take all the stock themselves, not intending that stock shall be issued by the company to future stockholders but intending to sell their own stock in the market.

3. Cases where the promoters intend that the company shall issue stock to subscribers as distinguished from cases where the promoters have no such intention.

4. Cases where the promoters make a full disclosure to future subscribers or allottees.

Let us consider these four classes of cases in their order, and first the cases where the organizers intend to retain all the stock. Of these cases the Massachusetts court said: [19]

> "The real ground of the decisions of which *Salomon* v. *Salomon* [(1897) A. C. 22] is a type, is that the corporation is estopped by the circumstance that all persons with financial concern in the matter have assented with knowledge and thus the lips of everybody are sealed. It is not that no wrong has been done, but that whatever wrong has been done has been condoned."

That is to say, if A. and B. who are carrying on a business as partners determine to incorporate it for the convenience and protection of themselves and their families, and, anticipating the growth of the business, choose to turn the partnership assets over to the corporation for twice their present value, they violate a fiduciary duty to the corporation even though they intend to remain the proprietors of all the stock so long as they live, and to transmit it at their deaths to their wives and children. No one, to be sure, can complain. Nevertheless a wrong is done which the organizers, being the owners of all the stock, forthwith condone. Could anything be more extravagant than the proposition that the corporation is wronged? To such lengths was the Massachusetts court carried in working out the theory of fiduciary duty to the corporation.

But this is not all. If there is anything clearly stated in the opinion of the court, it is that the organizers or promoters who have done the wrong cannot condone it by anything they themselves do.

> "It would be a vain thing," said Mr. Justice Rugg, "for the law to say that the promoter is a trustee subject to all the stringent liabilities which inhere in that character, and at the same time say that, at any period during his trusteeship and long before an essential part of it was executed or his general duty as such ended, he could, by changing for a moment the cloak of the promoter for that of the director or stockholder, by his own act alone, absolve himself from all past, present, and future liability in his capacity as promoter." [20]

According to this principle, again and again asserted, the corporation could never be said to forgive the wrong until it was repre-

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[19] 203 Mass. 159, 192.

[20] *Id.*, 188.

sented by an independent board of directors, or by stockholders uncontaminated by the original breach of trust duty — until innocent stockholders, with full knowledge of the facts, ratified the transactions between the organizers and the company. The position of the court involves a flat self-contradiction, or compels them to recognize the *Salomon* v. *Salomon* class of cases as constituting an exception to their general rule.

The same fate befalls the theory of the court as to the cases where the promoters take all the stock in payment for their properties. Then, no matter how excessive the price, the promoters incur no liability. The corporation is wronged, but somehow forgives the wrong or is estopped to complain. But how does it forgive or how is it estopped? No one has assented except the promoters themselves, and they *ex hypothesi* cannot change for a moment the cloak of the promoter for that of the shareholder and give their own consent to their own wrong. Nor can the corporation while acting under the control of the promoters properly be said to do anything which estops it from complaining of the wrong after it has reached a condition where independent action on its part becomes possible. The rule laid down by the court for these cases either involves another contradiction or must be recognized as another exception.

As to the third class of cases, in which the intention of the promoters to have their company issue stock to future subscribers has been treated as a matter of vital importance, it now appears that that intention is and always has been wholly irrelevant. In *Hayward* v. *Leeson*,[21] in the Bigelow case [22] when the court dealt with it on demurrer, and even in the final opinion of Mr. Justice Rugg,[23] all the talk that we find about "a scheme of corporate organization which contemplates an issue of stock to the unenlightened public" was as the crackling of thorns under a pot. It was, indeed, worse than idle. It was extremely misleading. For, according to the Massachusetts doctrine as finally formulated, the breach of trust is committed when the organizers or promoters sell the company their properties or their services at an excessive price, even though they do not intend to offer a share of stock for public subscription. Therefore neither their intention when they commit the breach of trust in respect to the subsequent issue of more stock, nor the actual

[21] 176 Mass. 310, 57 N. E. 656.

[22] 188 Mass. 315, 74 N. E. 653.

[23] 203 Mass. 159, *cf.* pp. 179, 186, 189.

issue of more stock, can possibly be material. Regardless of their intention, the breach of trust is irrevocably committed as soon as they have completed their transaction with the company. The wrong may afterwards be condoned, but condonation implies that the wrong has been done; and, so long as they control the outstanding stock and the board of directors, they cannot condone for the company the wrong which they themselves have done it. Unless stock is in fact issued to future subscribers, there may be no one financially interested in the company who has either a right to complain or any desire to see a suit brought by the company against the promoters. This, however, is an accidental circumstance which does not affect the quality or nature of the wrong. The issue of stock to future subscribers simply brings upon the scene innocent shareholders who either may act for the company in condoning the wrong or may institute proceedings in its name and for its benefit in order to make the promoters account for their unrighteous profits.

Finally we come to the cases where the promoters intend to disclose, and do disclose, all the facts to future subscribers. While the court is of the opinion that the promoters who have sold their properties to the corporation at an overvaluation have done it a wrong, they nevertheless assume in all their opinions that if the subscribers choose to take the stock after disclosure, neither they nor the corporation can complain. And this would be so even though a very small part of the capital stock — say $\frac{2}{15}$, as in the Bigelow case — were issued to innocent subscribers. Purchase after disclosure would be equivalent to assent on the part of the subscribers. It is impossible, however, to see why after becoming shareholders they should not say that the promoters had admitted their breach of fiduciary duty and insist that the corporation should sue the promoters to recover. When they buy as subscribers they do not deal with the promoters but with the company, and there is no reason why the company as such should stipulate either expressly or by implication that if the subscribers buy with knowledge of the earlier transactions between the corporation and the promoters, the subscribers must assent to what the promoters have told them. This would be permitting the promoters to use the corporation, still in their control, as a means of extorting forgiveness for their wrongdoing from persons who had not yet become shareholders. Free action on the part of the subscribers after they had become share-

holders would be necessary before it could be said that they had assented to the prior transactions.

And if it could with any propriety be said that subscribers who took the stock after disclosure were estopped to complain, this would not help matters unless they took a majority of all the stock. If they were a small minority in value, we should again encounter the difficulty that the promoters, being still the owners of a majority in value of the stock, could not possibly forgive their own breach of trust. Yet the Massachusetts court virtually admits that they can do this. Here is another contradiction, or a rule which the Massachusetts court must treat as another exception to their general rule of fiduciary duty.

The explanation of all these inconsistencies, irrelevancies, and contradictions is obvious. The gist of the action against the promoter is not a breach of duty to the corporation, but is a breach of duty — call it if you like a fiduciary or equitable duty, or call it the common-law duty not to deceive — which the promoter owes to future subscribers. Hence it is that if an issue of stock to future subscribers is not contemplated, there is no breach of duty at all. Hence it is that where the promoters subscribe and pay for all the stock which the corporation issues, there is no breach of duty to the company. Hence it is that the intention to issue stock to future subscribers has so often been spoken of by the Massachusetts court and by the English courts as essential to raise the duty to deal fairly with the company. Hence it is that a full disclosure to the future subscribers makes it impossible to hold that any wrong was done to the corporation. On the theory that the real wrong is done to the subscribers we do not have to recognize numerous exceptions to any general rule. All the classes of cases we have been discussing fall into place without difficulty or friction, and we have a number of subordinate rules which are all in harmony with one general principle.

It is, therefore, submitted that the Massachusetts doctrine can be supported only as a fiction by virtue of which, in a very limited class of cases, an injury committed directly against the subscribers in the nature of fraud and deceit may be carried back and metamorphosed into a breach of fiduciary duty on the part of the promoter toward the company — as a fiction by virtue of which an anticipatory breach of duty not to deceive the subscribers may be

treated as if it were a present breach of duty owed by the promoter to the company. And the Massachusetts doctrine can be supported only so far as in its application the subscribers, being the persons directly injured, are protected by and through the company which the promoter has used as an instrument of fraud. As the promoter has used the corporation as a means of deceiving the public, so the court, by invoking the fiduciary theory, may use the corporation as a means of righting the wrong. There seems to be a sort of poetic justice in such a proceeding; and it is obvious that in a proper case a single suit brought by the corporation may redress the wrongs suffered by all the subscribers, many of whom, if left to pursue their separate remedies, would probably not secure any redress at all. But the fiduciary theory cannot be employed with any propriety unless it does right the wrong. When the use of the fiction fails to right the wrong so far as the subscribers are concerned, and charges the promoter for an amount out of all proportion to the damages sustained by the subscribers, then the fiction is not being used with wisdom and discretion, but is being grossly abused.

Such a fiction is a dangerous thing to work with. Shadows are too easily mistaken for substances. A fiction cannot be handled with safety unless its true character is recognized and its reason and its purpose are kept constantly in view. If the fictitious character of the doctrine had been recognized by the court when they were asked to apply it in the Bigelow case, and if the court had kept in view its reason and its purpose, the corporation would either not have been allowed to recover at all or to recover only as trustee for the original subscribers; and the amount for which the promoters would have been held accountable would have been only the amount required to make the original subscribers whole. By failing to recognize that the trusteeship was a fiction; by declaring that the subscribers were the persons directly injured, and by declaring in almost the same breath that the corporation was the person directly injured; by treating the promoter as a real trustee for the company and not as a *quasi* trustee who might be treated as if he were a real trustee simply for the purpose of affording the subscribers the protection and the remedy to which they were entitled, the Massachusetts court came to grief. They had contrived to defeat the very object which they had set out to attain. They had pursued the

offender so far and through ways so devious that by the time they had caught him they had forgotten what his offense had been and whom he had offended. They stood ready to mulct him in a sum of over $2,000,000 without knowing whether a single person whom they believed he had cheated would be made whole, and without perceiving that less than a seventh of that amount would have sufficed to atone for all the wrongs of which he had been guilty.

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